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In Our Opinion...

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IMPROVING COMPLIANCE AUDITS—THE ASB's NEW STANDARD

by Doug Sauter
Technical Manager*

AICPA Auditing Standards Division

After a General Accounting Office study showed a large number of substandard audits of federal financial assistance, the AICPA formed the Task Force on the Quality of Audits of Governmental Units. The AICPA Task Force's objective was to develop recommendations to improve government audits. One of the task force's recommendations was that the ASB develop an SAS on compliance auditing.

In its last meeting of 1988, the ASB agreed to issue an SAS entitled, "Compliance Auditing Applicable to Governmental Entities and Other Recipients of Governmental Financial Assistance." The new SAS provides guidance that is intended to shore up independent accountants' audits involving compliance with laws and regulations.

SCOPE

The new standard sets forth the auditor's responsibility for testing and reporting on compliance with laws and regulations and tells how that responsibility is fulfilled. The standard notes that the auditor's responsibility varies according to the engagement; thus, the SAS is divided into three major sections: responsibility under generally accepted auditing standards (GAAS), responsibility under the GAO's *Government Auditing Standards* (including reporting on the internal control structure), and responsibility under the federal Single Audit Act of 1984.

GAAS RESPONSIBILITY

In an audit conducted in accordance with GAAS, the auditor's responsibility for consideration of laws and regulations is covered by SAS No. 54, *Illegal Acts by Clients* and SAS No. 53, *The Auditor's Responsibility to Detect and Report Errors and Irregularities*. Thus, the basic responsibility already exists in SAS Nos. 53 and 54. What the new SAS adds is "how

to" guidance on meeting that responsibility in audits of governments and in audits of other entities that receive financial assistance from a government.

Governmental Entities. Since governmental entities are subject to a variety of laws that are considered to have a direct and material effect on financial statement amounts, the SAS provides assistance to the auditor on assessing the risk of material misstatement from violation of those laws. The first step is for the auditor to obtain an understanding of the possible financial statement effects of those laws and regulations. This could include reviewing prior years' workpapers that document such an understanding, discussions with the client, and reviewing grants or loans to the entity. After obtaining this understanding, the auditor considers factors influencing audit risk and obtains an understanding of the internal control structure.

Nongovernmental Entities. When nongovernmental entities get governmental financial assistance—such as grants, loans, loan guarantees, and interest rate subsidies—they fall subject to laws and regulations that meet the SAS No. 54 definition of direct and material effect laws. The SAS spells out the kinds of laws and regulations to which the entity may be subject. These laws include those dealing with the types of services allowed to be provided with the financial assistance, eligibility requirements covering the recipients of assistance, and matching contribution requirements.

YELLOW BOOK RESPONSIBILITY

When an auditor is engaged to audit the financial statements of an entity in accordance with *Government Auditing Standards* (commonly referred to as the Yellow Book), the auditor assumes more reporting responsibilities than exist in a GAAS audit. There are two additional responsibilities: (1) reporting on compliance with laws and regulations, and (2) reporting on the internal control structure. However, the extra reports generated in a Yellow Book audit are based on the same procedures performed in a GAAS audit.

*Mr. Sauter is an employee of the American Institute of CPAs, and his views, as expressed in this article, do not necessarily reflect the views of the AICPA. Official positions are determined through certain specific committee procedures, due process and deliberation.

IMPROVING COMPLIANCE AUDITS

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Reporting on Compliance with Laws and Regulations. The Yellow Book requires the report on compliance to include positive assurance on items tested, negative assurance on items not tested, and a description of material instances of noncompliance. The SAS defines material noncompliance as “a failure to follow requirements or violations of prohibitions, contained in statutes, regulations, contracts, or grants that cause the auditor to conclude that the aggregation of the misstatements resulting from those failures or violations is material to the financial statements.” The SAS lists the basic elements of the report and includes examples of reports to be used in various situations.

Reporting on the Internal Control Structure. The Yellow Book requires a written report on the internal control structure in all audits. (SAS No. 60, *Communication of Internal Control Structure Related Matters Noted in an Audit*, requires a report—oral or written—only when the auditor notes reportable conditions). The report required under the Yellow Book is more comprehensive than the SAS No. 60 report and includes the identification of the internal control structure elements, a description of the scope of the auditor’s work, and, if applicable, a reference to separate communication to management of deficiencies that are not significant enough to be reportable conditions as defined by SAS No. 60. The new SAS gives guidance on complying with the Yellow Book reporting requirements and provides illustrative reports.

SINGLE AUDIT ACT RESPONSIBILITY

The Single Audit Act (Act) and OMB’s Circular A-128, “Audits of State and Local Governments” (A-128), require state and local governments that receive \$100,000 or more in financial assistance in a fiscal year to have an audit performed in accordance with the Single Audit Act. (Governments receiving \$25,000 to \$100,000 may elect to follow the Single Audit requirements or separate program audit requirements.) The Act and A-128 require the auditor to report on compliance with laws and regulations that may have a material effect on each “major” federal financial assistance program. To comply with these provisions, the new SAS requires the auditor to test and report on compliance with major program “general requirements” and to perform auditing procedures necessary to provide an opinion on compliance with major program “specific requirements.” Whereas the reporting guidance in the AICPA Audit and Accounting Guide, “Audits of State and Local Governmental Units,” covered the compliance with both general and specific requirements in the auditor’s opinion on major program compliance, the SAS clarifies the auditor’s testing responsibility by separating the report on the general requirements from that on the specific requirements.

The specific requirements generally deal with the following matters: types of services allowed, eligibility, matching, reporting, and special tests and provisions. The SAS pro-

vides guidance for auditing and issuing an opinion reporting on compliance with the specific requirements including matters such as: identifying major programs, determining materiality, assessing risk, subrecipient considerations, and evaluating the results of auditing procedures. Also, the SAS includes a new requirement that the auditor obtain certain written representations from management.

The general requirements deal with the following six items: political activity, prevailing wages for construction workers, civil rights, cash management, relocation assistance and real property acquisition, and federal financial reports. As the SAS acknowledges, to test compliance with these requirements the auditor may use the procedures spelled out in the “Compliance Supplement for Single Audits,” a supplement to A-128 issued by the OMB, as a safe harbor. However, since the Compliance Supplement only sets forth the nature of suggested procedures, the auditor must use judgment to determine the extent of such procedures. The SAS specifies the basic elements of the auditor’s report on compliance with the general requirements. The report includes a statement of positive assurance on compliance with respect to the items tested and negative assurance with respect to the items not tested.

In addition, the SAS clarifies the auditor’s responsibilities when reporting on compliance with certain laws and regulations applicable to nonmajor federal financial assistance programs.

DUE PROFESSIONAL CARE

Governmental entities generally are subject to a variety of audit requirements. Also, the auditor’s responsibility for testing and reporting on compliance with laws and regulations varies according to the terms of the engagement. The Statement suggests certain procedures the auditor should consider performing in order to exercise due professional care in understanding the type of engagement to be performed. These procedures include discussions with management, inquiries of appropriate oversight organizations, and review of available information concerning governmental audit requirements.

IMPROVING AUDIT QUALITY

The Statement sets forth the auditor’s responsibilities for testing and reporting on compliance in various engagements and explains how the auditor goes about meeting those responsibilities. By combining existing audit requirements from various sources, the SAS should assist the auditor in compliance auditing engagements by clarifying the applicable guidance. Also, by elevating certain of the existing guidance to the level of authority of an SAS, the Auditing Standards Board will have raised auditors’ awareness of those audit requirements. The new SAS is a step toward improving the quality of engagements designed to test and report on compliance with laws and regulations.

TECHNICAL PLAN HIGHLIGHTS

Letters for Underwriters (AICPA Staff: JANE MANCINO). The Board is considering revisions to SAS No. 49, *Letters for Underwriters*, to reconcile that SAS with services that can be performed under the *Attestation Standards*. *Schedule*: The Board will consider an issues paper at its April 1989 meeting.

Service Center Produced Records (CONNIE WELCH). The Board is considering superseding SAS No. 44, *Special-Purpose Reports on Internal Accounting Control at Service Organizations*, to meet the needs of auditors of organizations using EDP service centers and to conform that SAS with SAS No. 55, *Consideration of the Internal Control Structure in a Financial Statement Audit*. *Schedule*: The Board plans to consider proposed guidance at its May 1989 meeting.

Audit Sampling (RAY JOHNSON). The *Audit Sampling* audit guide will be updated to conform the guide to the terminology in the new SAS Nos. 52–61 and to provide better “how to” guidance for applying SAS No. 39, *Audit Sampling*. *Schedule*: The revised audit guide will be available in the fourth quarter, 1989.

Special Reports (MIMI BLANCO-BEST). The Board has approved the issuance of SAS No. 62, *Special Reports*. This SAS supersedes SAS No. 14, *Special Reports*, and prescribes changes to special reports that reflect the new requirements of SAS No. 58, *Reports on Audited Financial Statements*, and clarifies requirements for issuing reports on special or incomplete presentations. *Schedule*: Final SAS to be published second quarter, 1989.

Control Risk Audit Guide (CONNIE WELCH). The Board is developing an audit guide to assist auditors in implementing the new requirements of SAS No. 55, *Consideration of Internal Control Structure in a Financial Statement Audit*. *Schedule*: The Board plans to expose the proposed audit guide in 1989 prior to the effective date of SAS No. 55.

Updated Audit Reports (PATRICK MCNAMEE). The Auditing Standards Division, working with various AICPA committees, is developing guidance that will update existing audit guides to reflect the new reporting requirements of SAS No. 58, *Reports on Audited Financial Statements*, and SAS No. 60, *Communication of Internal Control Structure Related Matters Noted in an Audit*. Statements of Position 89-1 and 89-2—“Reports on Audited Financial Statements of Brokers and Dealers in Securities” and “Reports on Audited Financial Statements of Investment Companies”—were published in January 1989. (See “Recent Division Publications” on page 4.) *Schedule*: A statement of position amending the audit guide for state and local governments will be issued in the second quarter, 1989.

Auditing Procedure Study: Audits of Small Businesses (DOUG SAUTER). The auditing procedure study *Audits of Small Businesses* is being revised to reflect the new SASs (52–61). The chapters on evaluating internal controls

and on analytical procedures will be revised to discuss the implementation of SAS Nos. 55 and 56, *Consideration of the Internal Control Structure in a Financial Statement Audit* and *Analytical Procedures*, in the small business audit. Other changes will be made throughout the study to provide guidance that is consistent with the new standards. *Schedule*: The revised auditing procedure study will be available by the fall of 1989.

Compliance Auditing (PATRICK MCNAMEE). The Board has voted to issue a final SAS on compliance auditing. This SAS addresses applying SAS Nos. 53 and 54—on errors, irregularities, and illegal acts—to audits of governments and other entities that receive government assistance. It also provides guidance on testing and reporting on compliance with laws and regulations in engagements under *Government Auditing Standards* and the Single Audit Act, and it addresses reporting on the internal control structure under *Government Auditing Standards*. *Schedule*: The final SAS will be available in the second quarter, 1989.

Codification Framework (JANE MANCINO). The Board is discussing a revision to the framework of the *Codification of Statements on Auditing Standards* that will make the *Codification* more relevant and useful to practitioners. The proposed framework would organize the codification according to the flow of work in an audit. *Schedule*: The Board will consider further development of that framework at its June 1989 meeting.

Reporting on Internal Control (CONNIE WELCH). The Board is considering alternative models for general purpose reporting on an entity’s internal control structure, determining the circumstances in which each of those models is appropriate for such reporting, and developing performance and reporting guidance under each of the appropriate models. *Schedule*: At its April meeting, the Board will discuss issues related to providing limited assurance about an entity’s internal control structure.

Reliance on Internal Audit (MIMI BLANCO-BEST). The Board is considering revisions to SAS No. 9, *The Effect of an Internal Audit Function on the Scope of the Independent Auditor’s Examination*, to reflect the audit risk model, SAS No. 55, and current practice. *Schedule*: The Board will discuss a revised draft of a proposed SAS at its April meeting.

Internal Auditor Procedure Study (ALAN WINTERS). The Auditing Standards Division, in conjunction with the Canadian Institute of Chartered Accountants, is preparing an auditing procedure study on the use of internal auditors’ work. *Schedule*: This procedure study will be published in the second quarter, 1989.

Use of Confirmations (DOUG SAUTER). The Board created a task force to develop guidance on the use of confirmation procedures in audit engagements. The task force has developed a notice to practitioners that outlines revisions

TECHNICAL PLAN HIGHLIGHTS

(continued from page 3)

made to the standard bank confirmation and discusses why those revisions were made. *Schedule:* Issuance of the revised bank confirmation form will be discussed at the April 1989 Board meeting.

Financial Forecasts and Projections (MIMI BLANCO-BEST). The Board created the Forecasts and Projections Task Force to deal with problems encountered in implementing the guidance in the Statement on Standards for Accountants' Services on Prospective Financial Information. *Schedule:* A statement of position titled *Questions Concerning Accountant's Services on Prospective Financial Information* will be issued in April 1989. An exposure draft of a proposed statement of position that will provide guidance to practi-

tioners on reporting on partial presentations of prospective financial information and prospective financial statements for internal use only will also be issued in April 1989.

Computer Auditing (JANE MANCINO). The Computer Auditing Subcommittee and related task forces are responsible for developing guidance for auditors about the effects computers have on the audit process and advising the Board and other senior technical committees, and the membership on computer-related matters. The Subcommittee is currently drafting guidance in the form of an auditing procedure study that addresses the implementation of SAS No. 55, *Consideration of the Internal Control Structure in a Financial Statement Audit*, in a larger computer environment. *Schedule:* The procedure study will be published in the second quarter, 1989.

RECENT DIVISION PUBLICATIONS

Two statements of position (SOPs) updating illustrative auditors' reports in audit and accounting guides were published in January 1989. SOP 89-1, "Reports on Audited Financial Statements of Brokers and Dealers in Securities," (product number 014785) updates the guide *Audits of Brokers and Dealers in Securities*. SOP 89-2, "Reports on Audited Financial Statements of Investment Companies," (014790) updates *Audits of Investment Companies*. These publications can be obtained by writing the AICPA's order department at 1211 Avenue of the Americas, New York, NY 10036.

Also, three auditing interpretations were published in the February 1989 *Journal of Accountancy*. These interpretations deal with SAS No. 60, *Communication of Internal Control Structure Related Matters Noted in an Audit*; AU section 561, "Subsequent Discovery of Facts Existing at the Date of the Auditor's Report"; and AU section 558, "Required Supplementary Information."

KEEP AN EYE OPEN FOR

Conforming Changes in Codification of SASs: The issuance of SAS Nos. 53 through 61 in April 1988, and of SAS No. 62 in April 1989 introduce auditing standards terminology, concepts and procedures that affect other SASs. To ensure consistent usage of terms among all SASs,

the AICPA staff, in conjunction with the Auditing Standards Board (ASB), harmonized the existing SASs with the terms in SAS Nos. 53-62 in the edition of the 1989 *Codification of Statements on Auditing Standards* and the 1989 *Codification of Statements on Standards for Accounting and Review Services*. These publications are scheduled for publication in April 1989.

CPA EXAM GRADERS NEEDED

The AICPA's Examinations Division is seeking CPAs and JDs to assist in grading the May 1989 Uniform CPA Examination.

The grading period begins about three weeks after the exam is given and continues for six to eight weeks. Graders must provide a minimum of three seven-hour days each week, excluding Sundays.

For additional information and
an application write to:

AICPA
Examinations Division
1211 Avenue of the Americas
New York, NY 10036-8775

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Editor:
Patrick McNamee
Director, Audit & Accounting Guides
Administrative Editor:
Ken Lundstrom

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